



OFFICES OF THE COUNTY EXECUTIVE

Isiah Leggett
County Executive

Timothy L. Firestine
Chief Administrative Officer

September 30, 2013

Members of the Montgomery County Council

I am pleased to present to you the Quarterly Report of the Montgomery County Employees' Retirement System ("ERS") for the quarter ended June 30, 2013. This quarterly report is designed to assist you in understanding the current status of the ERS. This report was prepared pursuant to the provisions of the Montgomery County Code.

History

The Employees' Retirement System was established in 1965 as a cost-sharing multiple-employer defined benefit pension plan providing benefits to the employees of Montgomery County and other agencies or political subdivisions who elect to participate. The System is closed to employees hired on or after October 1, 1994, except public safety bargaining unit employees and employees who elect to participate in the Guaranteed Retirement Income Plan. There were approximately 5,440 active members and 5,660 retirees participating in the ERS as of June 30, 2013.

Performance Results

The total return achieved by the ERS assets for the quarter was a decline of 1.21%, 105 basis points ahead of the 2.26% decline recorded by the policy benchmark. For the one year period ending June 30, 2013 the ERS' gross return (before fees) was a gain of 10.85%, 237 basis points ahead of the 8.48% return recorded by the policy benchmark. The one-year gross return places the ERS' performance in the bottom 25% of the universe of comparable pension funds constructed by the Board's consultant, Wilshire Associates. Our annualized performance of 12.44% for the three-year period and 6.49% for the five-year period, ranked in the top 25% of the universe for both periods. The asset allocation at June 30, 2013 was: Domestic Equities 24.4%, International Equities 16.1%, Global Equities 2.0%, Fixed Income 24.2%, Inflation Linked Bonds 9.0%, Commodities 4.4%, Private Equity 7.4%, Private Real Assets 5.5%, REITS 1.8%, Opportunistic 3.8%, and Cash 1.4%. We estimate that the funded status of the ERS was 78% as of June 30, 2013, a slight increase from the June 30, 2012 level. The actual funded status will be affected by the ERS' membership experience, as well as demographic and economic changes and may be higher or lower when calculated by the actuary during the next valuation.

Major Initiatives

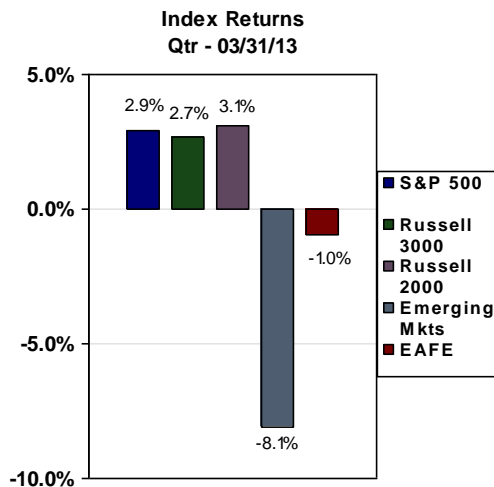
During the quarter, the Board approved the restructurings of the commodities and opportunistic allocations, and the structure of the global REIT allocation. Within the private real assets sector, the Board made a commitment of \$12,000,000 in Lime Rock Resources III-A, L.P. The Board also hired Wellington to manage \$64,000,000 in their commodities strategy and BlackRock to manage \$47,000,000 in their global REIT strategy.

Capital Markets and Economic Conditions

The US economy expanded at a 1.8% annualized rate during the first quarter of 2013, following a modest 0.4% gain in the fourth quarter of 2012. The increase in GDP from the prior quarter was primarily due to higher consumer spending, which grew at an annual rate of 2.6%, as households dipped into their savings in order to increase purchasing. The economy added 195,000 new jobs in June, which beat economist's expectations of 155,000. As government employment continues to be cut back, the private sector has been the largest driver of job creation in the economy. The unemployment rate remained

unchanged from the prior month at 7.6%, and still remains well above the Fed's target level of 6.5%. The Consumer Price Index rose 0.5% in June, as the cost of gasoline, housing, medical care, clothing, and food all rose. June home prices were up 12.1% year over year, and all 20 cities in the Case-Schiller Index posted gains on a monthly basis. Overall, the economy continued to see home prices rise, but the pace may be slowing due to buyers being discouraged over rising interest rates.

Public Equity Markets: U.S. equities advanced modestly in the second quarter as better-than-expected economic data offset investors concerns over the potential wind down of the Federal Reserve's bond buying program. The S&P 500 Index reached a new high during the quarter. Larger capitalization stocks

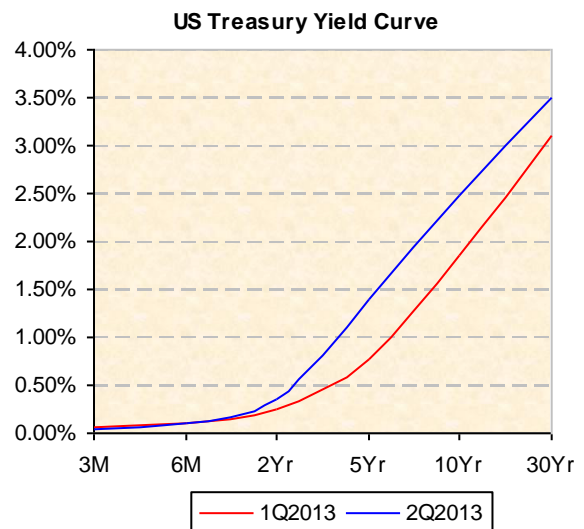


(as represented by the S&P 500 Index) underperformed their smaller counterparts. Seven out of the ten sectors of the S&P 500 advanced with Financials, Consumer Discretionary, and Health Care performing the best. Our combined domestic equity performance was a gain of 3.18%, outperforming the 2.69% gain recorded by the Russell 3000 benchmark.

International developed markets continued to lag their domestic counterparts as U.S. monetary policy fears weighed on market sentiment. The European region advanced by the strength of the German and French markets. The Asia-Pacific region lagged despite Japan generating the highest return among developed markets. Emerging markets declined during the quarter as Chinese economic concerns, along with U.S. monetary policy fears, weighed on the markets. Furthermore, large scale public protests in Brazil and Turkey caused these markets to strongly underperform. During the quarter, developed markets, as measured by the

MSCI EAFE Index, declined 0.98%. Most of the developed markets were in negative territory with Australia and New Zealand leading the decliners. Emerging Markets fell by 8.08%, underperforming their developed counterparts, with all countries posting negative returns. Our combined international equity performance was a loss of 1.24% for the quarter, outperforming the 3.11% loss recorded by the MSCI ACWI ex-US Index.

Fixed Income: U.S. Treasury yields rose significantly during the quarter due to signs of improvement in the U.S. economy and comments from Fed Chairman Ben Bernanke who indicated that the Fed may begin to taper its \$85 billion bond buying program as early as September. The yield curve steepened significantly (shown in the chart to the right) as the spread between 2-year and 10-year Treasuries, the main gauge of the yield curve, widened by 53bps to 213bps. For the quarter, the 2-year Treasury yield ended at 0.36%, up 12bps, while the 10-year Treasury yield increased by 64bps to 2.49%. Returns were negative for all fixed income sectors with high yield bonds, which are less sensitive to rising interest rates, the best performer. For the quarter, the Merrill High Yield Index declined 1.35%, the Barclays Aggregate declined 2.32% and the Barclays Long Govt/Credit Index declined 6.11%. Our combined fixed income performance for the quarter was a loss of 3.87%, in-line with the custom benchmark's 3.82% decline. Our global inflation-linked bond portfolio, combined with the portable alpha overlay, declined 11.77% for the quarter, in-line with the 11.84% decline recorded by the benchmark as real rates moved higher in conjunction with nominal rates.



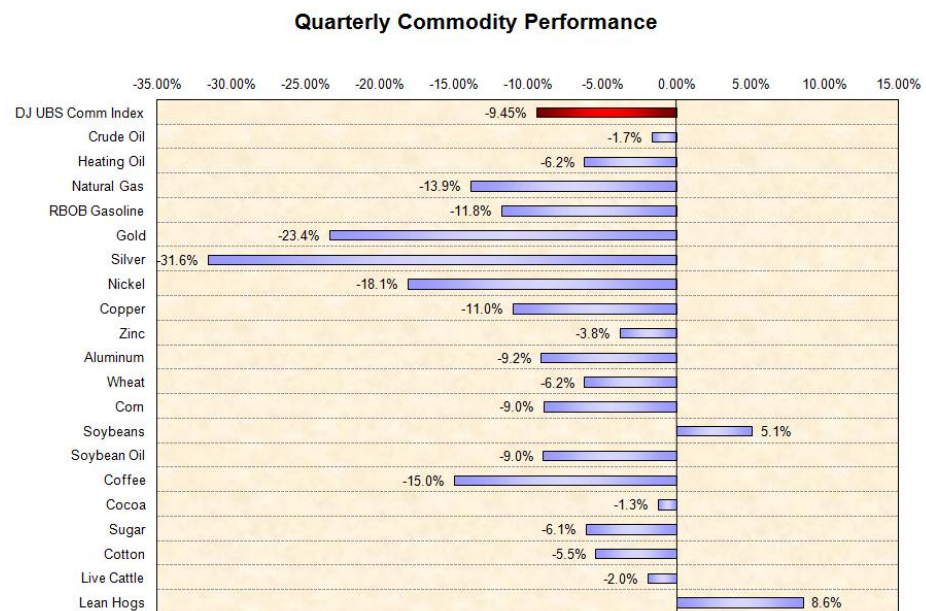
Opportunistic: Hedge funds, as measured by the HFRI Composite Index, declined 10bps in the second quarter. After posting positive returns in April and May, hedge funds fell 1.3% in June, the first monthly decline in 2013, as global markets experienced broad based declines. Event driven strategies were the best performers, returning 2.3% in the quarter. Relative value and long/ short equity were also positive for the quarter while multi-strategy managers, global macro and CTAs all produced negative returns. Trend following strategies suffered due to sharp reversals in the credit and equity markets in May and June. Global Macro funds declined 1.6% in the second quarter as exposures to emerging markets and commodities, particularly metals, detracted from performance. Fund-of-Hedge Funds returns, as measured by the HFRI Fund-of-Funds index, were flat in the second quarter. Our opportunistic portfolio returned 1.58%, net of management fees, in the second quarter, outperforming the HFRI Fund-of-Funds benchmark.

Private Equity: Through the second quarter, aggregate investments by private equity firms were slightly higher versus the same period in 2012, led by a rise in buyout investment activity. Exit activity remains relatively muted due to a reduction in corporate acquisitions; however, the positive news regarding exits is the significantly increased number of exits attributable to initial public offerings. Purchase valuations are almost exactly in line with 10-year averages, while leverage use is slightly above its historic average due to low interest rates and attractive financing terms from lenders. During the quarter, our private equity managers called a combined \$3.9 million and paid distributions of \$9.6 million. Our current allocation to private equity is 7.4%, with a market value of \$233.4 million. From its 2003 inception through December 31, 2012, the private equity program has generated a net internal rate of return of 6.7% versus an 8.1% return for the dollar-weighted public market equivalent (the Russell 3000 Index plus 300 basis points).

Private Real Assets: In commercial real estate, transaction activity through the second quarter is up nearly 30% versus the same period a year earlier. The changes were led by robust sales volume in both the U.S., across all property types, and in Asia, mainly in developable land. Investors also sought opportunities in riskier properties as demonstrated by the increase in activity in secondary markets and non-core assets. In energy markets, favorable oil pricing relative to natural gas continued to drive oil drilling activity. During the quarter, our managers called a total of \$5.8 million and paid distributions of \$6.5 million. Our current allocation to private real assets is 5.5%, with a market value of \$174.1 million. From its 2006 inception through December 31, 2012, the private real assets program has generated a net loss of 2.0% versus a 7.0% gain for the long-term benchmark CPI plus 500 basis points. The underperformance versus the benchmark is partially attributable to the young age of the portfolio, with an average maturity of less than four years.

Commodities: The Dow Jones-UBS Commodity Index declined 9.45% during the quarter led by the metals and energy sectors. Industrial metals fell on concerns over economic conditions in Europe and China. Precious metals dropped sharply on further indications that monetary easing would come to an end. Within the energy sector, oil futures fell, reversing first quarter's gains. Oil prices were challenged by rising U.S. inventories and natural gas prices were pressured by cooler

weather in the Northeast U.S. Within the agriculture sector coffee, corn, and sugar future prices declined on improving supply conditions. During the quarter, our commodities portfolio declined 8.70%, 75bps ahead of the DJ UBS Commodities Index.



REITs: During the second quarter, global REITs fell substantially in May following the Federal Reserve's mention of a possible reduction in quantitative easing. Asian REITs detracted the most from performance, in large part due to Japan where they had risen significantly earlier in the year. Global REITs, as measured by the FTSE EPRA/NAREIT Developed Index, lost 3.85% for the quarter, while our global REIT portfolio returned 2.80%, outperforming the benchmark.

Additions

The primary sources of additions for the ERS include contributions from members and employers and investment income. The following table displays the source and amount of additions for the quarter ending June 30, 2013 and fiscal year-to-date.

Employees' Retirement System Contributions and Investment Income (millions)

	Qtr 6/30/2013	Fiscal YTD
Employer Contributions	\$ 31.6	\$ 127.8
Member Contributions	6.2	24.8
Net Investment Income	(43.6)	297.9
	\$ (5.8)	\$ 450.5

Deductions

The deductions from the Employees' Retirement System include the payment of retiree and survivor benefits, participant refunds, and administrative expenses.

Employees' Retirement System Deductions by Type (millions)

	Qtr 6/30/2013	Fiscal YTD
Benefits	\$ 52.3	\$ 208.9
Refunds	0.3	1.8
Administrative Expenses	0.9	2.5
	\$ 53.5	\$ 213.2

Outlook

Recent economic data has been mixed, as the economy continues to show modest advances, albeit at a slower pace than what policymakers had anticipated. Investors continue to anxiously await updates as to when the Federal Reserve will begin to taper their monthly asset buying stimulus policies. Although interest rates are expected to remain near historical lows for the foreseeable future, a larger than expected reduction in asset purchases by the Fed could have short-term adverse affects on both the equity and bond markets. Also, a government showdown over the federal budget and debt ceiling looms over the market during the latter half of 2013.

Despite the uneven economic data, the U.S. recovery is still on solid footing, as the odds of dipping back into another recession have greatly diminished. Consumer spending and current GDP readings continue to support an economic revival, and it appears that even the current government cutbacks have done little to impede the economic progress towards recovery. Employment and housing data are also showing continuous signs of improvement, and both are expected to continue their positive trends throughout the remainder of the year.

Sources: Bloomberg, Northern Trust, MSCI, S&P, Pyramis Global Advisors, FRM, Wilshire Associates, Bridgewater, JP Morgan, BlackRock, PE Hub, Private Equity Analyst, Pitchbook, Real Capital Analytics, RE Alert, Schroder, Oil & Gas Investor.

**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF PLAN NET ASSETS**

June 30, 2013

Assets

Equity in pooled cash and investments	\$ 1,099,486
Investments:	
Northern Trust	3,158,764,997
Aetna	1,126,399
Fidelity - Elected Officials Plan	341,243
Fidelity - DRSP	12,334,262
Total investments	3,172,566,901
Contributions receivable	6,292,224
Total assets	3,179,958,611

Liabilities

Benefits payable and other liabilities	5,937,676
Net assets held in trust for pension benefits	\$ 3,174,020,935

**EMPLOYEES' RETIREMENT SYSTEM
STATEMENTS OF CHANGES IN PLAN NET ASSETS**

June 30, 2013

	Quarter	Fiscal YTD
Additions		
Contributions:		
Employer	\$ 31,629,875	\$ 127,780,710
Member	6,231,852	24,828,764
Total contributions	37,861,727	152,609,474
Investment income	(39,014,484)	314,704,472
Less investment expenses	4,645,786	16,823,449
Net investment income	(43,660,270)	297,881,023
Total additions	(5,798,543)	450,490,497
Deductions		
Retiree benefits	38,197,565	153,692,921
Disability benefits	11,730,335	46,636,836
Survivor benefits	2,334,807	8,617,952
Refunds	306,027	1,803,993
Administrative expenses	892,159	2,491,554
Total deductions	53,460,893	213,243,256
Net increase (decrease)	(59,259,436)	237,247,241
Net asset held in trust for pension benefits		
Beginning of period	3,233,280,371	2,936,773,694
End of period	\$ 3,174,020,935	\$ 3,174,020,935